Daniel Lewin

President

Lewin Capital Management Ltd.

March 7, 2024

Daniel Lewin is President of Lewin Capital Management Ltd in Vancouver, British Columbia, Canada. Daniel spoke with the editors of the Ben Graham Centre's Newsletter about his experience being a value investor.

What brought you into finance in the first place and did you consider anything else?

I grew up in a small town in the Kootenays in southeastern BC. Back then, the academic track was science, so I went into UBC's science program. It didn't take long, in one of the first chemistry labs, for me to realize this is not where I want to be. I don't know why business didn't occur to me; I wasn't really exposed to that as an undergraduate option. I had, however, been exposed through my dad. My dad was a retired lawyer, and he ended up founding a little company that sold industrial supplies. He actually took it public on the Alberta stock exchange years and years ago. So, I had been exposed to annual meetings and business and things. Once I got the wind of commerce as an avenue it just really fit.

I was tiny, but I remember coming and serving coffee to the directors as a young boy. Eventually, he let me run some of the annual meetings – it was a very small company. But that was formative exposure to business for me.

What is it that attracted you to investing specifically, and why did you pursue it out of undergrad?

I got lucky and got into the UBC Portfolio Management Foundation, back then it was, I think, $700,000 of real money. That 700,000 felt very real and, every two months we were up against the client committee trying to justify our investment actions and they were, I'd say some of the toughest clients I've ever had to face. So, it was really good training. Just getting a little taste through that, of the idea that you are pitting your intellect against the market. It's the most competitive thing, a world where everyone is competing hard to try to make money. Once I got a taste for that, I really was hooked.

What would be the most memorable event you've had in your career ad what was your biggest learning from that event?

I think the tech bubble was a good example. During the tech bubble, it was tough because I was covering the non-tech stocks, and they weren't doing very well. They were called the "the old economy stocks."

I went to a cocktail party, and a friend of mine, who was a broker, was at the party. He said, "What are you covering these days?" I told him, the breweries and railways and steel companies, etcetera. And he just had this pitied look on his face like. And he basically said it out loud. He said, "Aren't you worried you're going to be out of a job soon? Because these stocks, you know the technology stocks, they're taking over the world." And I couldn't have felt lower.

> "But you know what? What this taught me was that the market overshoots. Especially on big ideas. I think the markets are really good at discounting incremental bits of information, like a tuck-in acquisition or a quarterly earning report of whatever."

But the market often makes mistakes over and under shooting when big changes happen in the world and the Internet was one of those big changes. And sure enough, just about when you feel that you can't take any more pain, that's the peak and you know the riches flow in after that and it was much, more more exciting to be in old-economy stocks.

With respect to conducting due diligence, how do you weigh the option opinion of third-party information providers without getting too caught up in their predictions, their biases, their opinions?

I always recommend reading the filings first. It doesn't matter how much experience you have, if you start with a someone else's opinion, it's really hard not to be biased by that. As you're reading the filings, think about, "What do I need to know to understand how this company makes money?"

How long does it take you to ramp up on a name?

It depends. If it's an industry that I'm familiar with, it might take a few weeks or months. If it's an industry that I'm not familiar with, it might take, four or five years to get to a spot where you feel like you know enough to make an informed decision. At that point it's about expanding my circle of competence.

A lot of people talk about the role of information from people involved with the business on a day-to-day basis. What roles does that type of information play in your diligence process?

I really like Phil Fisher. I really identify with the scuttlebutt idea. I don't know if there are many opportunities for drilling down beyond the CEO and CFO or an IR team or whatever that generally comes in, maybe on a plant tour where you can meet other people which can certainly be interesting. But I don't know that they're really avenues for that sort of research.

I certainly haven't used them other than when it's an investor day or a company tour. But you can also learn a lot from competitors too. And if you're wondering about an asset, a new product or whatever is coming on, getting the competitors read on that can be super valuable.

When you have a position or a business that you think is incredible and it's run up, how do you go about the decision to trim or sell?

What I'd say is it's usually less about valuation than people think. Valuation is maybe reason #4 in the decision to sell.

The main reason to sell would be you made a mistake. And recognizing that early and being intellectually honest with yourself, that what's happening in the business is not what you anticipated in the investment thesis, and reassessing it quickly as you can, is vital.

> "When you're looking at businesses that are trading at a big discount intrinsic value, there can be a feeling of precision from your calculations. The reality is, it's not that precise. So, if you see stock move 10 or 15%, unless it's a mature, slow growth business, I would say it is unlikely to cause me to want to rethink the portfolio for small move in price like that."

How often do you revisit your investment thesis? Do you have a systematic way of doing it?

I run a focused portfolio. Currently we have 9 positions across 8 industries. So, I look at everything every day.

In terms of the formal revisiting of thesis, I would recommend a decision journal. I started doing this at the beginning of my career. When you make an investment decision, you write the name of the stock, buy or sell, and date. Maybe write down the level of the market at the time to see if the market just went up and it wasn't the idiosyncratic reason you made money. Then write to yourself, a few lines on the essence of your decision and why you want to buy or sell. Then file that piece of paper away.

That can be super helpful because the human brain is not so good at being intellectually honest with itself. So you could make a decision, the stock could go up and upon looking back at your note you realize the reason the stock went up had nothing to do with your thesis. So, you were lucky in that instance. It's good to remind yourself of that. Then think about how you can learn from that and what you could have done better.

Equally, if you make an investment and you want to prevent thesis creep, you need to know what you are justifying. There, a decision journal can really help.

Do you set downside targets when you invest? Is there a price per share below which you would close your position?

No, it would be related to something fundamental in the business that I would sell. I wouldn't sell for just price reasons.

At the same time, you have to be thinking from a behavioral perspective. If a business that you own drops by a great deal, I'm averse to the doubling down phenomenon because I think that often your brain really wants to prove how right your initial thesis was, and it's difficult to get that cloud out of your judgment. I like that Warren Buffett quote: "You don't have to make the money back the same way you lost it."

So, I don't have a target like that. Hopefully, if you're watching the businesses closely enough and something's not working in the business, the price is up. Just identify it and take action as soon as possible.

What is your process for assessing company management and what sort of things do you look for in a capable and competent management team?

I think a lot of the assessment of management you can do is reading the proxy and last 10 years of 10-Ks or annual reports and seeing if the world turned out as the company hoped it would. There are times interviewing management is really important.

So I spent a lot of time trying to perfect that process and a couple of tips would be I'd say: be very respectful of management's time, and be prepared - read all the filings before you sit down with them. Have a solid reason for the call, and be ready with the questions you're going to ask.

I find too that if you do get in front of management, and you tell them you've read all the filings and are interested in buying, but need to learn this one thing, most management teams will stop and answer that question. And you don't need an hour of their time for that.

Have there been management interviews where you took away something that was actionable?

I remember I was once interviewing the CEO of Potash Corporation, a fertilizer producer. This was in the mid 90s and the business is generally stable but cyclical.

I had met the CEO a number of times by the time this interview took place. And I said, what's new? He said the Russians have discipline.

He meant a lot of potash rock was located in Russia – there's two big producers there who were producing for hard currency since the Soviet Union collapsed. So they were a very <u>un</u>disciplined producer and Potash Corp was the one trying to pick up the slack in the industry. And idle excess capacity to keep the price up, which would be really good. Or, if you control the most tons, you can get a high margin per ton, that's very valuable.

I thought this was interesting and that that totally changed thesis that here was here was an inflection point where one big competitor finally got discipline. So, you can definitely learn interesting things from management interviews.

Another interview technique tip would be to never ask a leading question. Don't ask a question that the answer that you want to hear is in the body of the question. And no yes or no questions.

Has your initial assessment of the management team ever been incorrect and how did your process fail you in that sense?

Oh, certainly. I think you have to judge management on their actions. Also, if management knows what you want to hear in advance, then they can speak to it and it's easy to deceive. You put yourself in that position and you walk out of the meeting elated under the impression that they're going to do X, Y and Z, exactly the things you were hoping they'd do. And then they end up not doing any of those, if not the opposite. So yeah, for sure that happens. You want to judge it by their actions.

There's obviously been a shift towards passive investing. How do you feel this shift has affected institutional managers in Canada and what can they do to deal with it?

"I think passive investing is a good idea. But like most things and most things in the market, it'll probably go too far, and people probably do get carried away with it. The market wouldn't work if it was 100% passive, there'd be no price discovery mechanism. So capital shifting towards passive in one sense it's eliminating competition which is a good thing for an active investor."

On the other side of it you might need to be even more patient to get price discovery to work. If you're buying something that is underpriced and compelling value or whatever, you need other people to recognize that too. But if all the money is passive, that's not really part of the game. I think patience is always required, but to the extent that that the market is more passive, there'll be more opportunities, but you're going to have to be even more patient with them.

Turning to your shareholder letter, you noted that the Magnificent 7 has been a large driver of S&P performance and I noted it makes up around 30% of the S&P 500. Do you think that the S&P 500 will become less concentrated over time? Or will there just be new companies to replace the Magnificent 7?

Well, that's a good question. I think historically narrowness in the market typically doesn't last forever. I think that business is just too competitive. The idea that a few large companies are winning; that's not constant, that's cyclical.

If you look at history, the market was super narrow in 1972 with the NIFTY 50. It was super narrow in 2000 and it was super narrow last year, or now. I don't think narrowness is a constant condition. I'd be surprised if the market stays narrow for 10 years.

You also mentioned you would never do private equity. Is there an anecdote or an experience that you can touch on that informs that opinion?

I recommend reading the Caesars Palace Coup. I felt that there was a lot of bad behavior on display in that book. That certainly isn't the industry, there's a lot of good people, good bright people in that business, of course. But the debt part of it doesn't work for me personally, I don't like the leveraged aspect of it.

I think the one thing that about private equity, which is tricky is the idea that they're able to mark their own portfolio, which I think the people in the industry shouldn't want that. It's a set of incentives you just wouldn't want to put in front of you.

How do you see yourself now between the two ends of the spectrum, between a deep value investor and a quality-growth investor?

There's so much to be learned from all those. Like you mentioned, Ben Graham, or Warren Buffett and Charlie Munger, you know, intellectual giants, right. It's amazing how much they've given us all to learn about investing, but I'd say the person that influenced me most directly was Philip Fisher and his book Common Stocks and Uncommon Profits written in 1958. I thought of it as basically a manual for starting my own company. You know, everyone looks at it in a different way, but that was the one that really resonated with me the most.

But yeah, I don't shy away from deep value provided there's some quality with it, and I'm also fine with owning a compounder type business. I think all those different types of ideas are fine.

How do you spend your time now that you're working by yourself, on a daily basis? How much of it is reading annual reports versus reading books?

I'd say I'm set up to do spend 90% of my day on research. Of one type or another. And yeah, I love reading. I like reading - books about industries are terrific. If you guys have any recommendations, please send them my way. And if you want, I'm going to show a slide in the presentation about some of the books I thought were formative [referenced at the end of the transcript]. And maybe there's something there you haven't heard of. It's pretty organic. My office is a little bit like a library. It's very quiet, right. The phone doesn't ring very often. I'd say mostly research all day.

What do you think the merits and drawbacks to interacting with other investors are? Trying to disprove your investment thesis can be helpful to bounce an idea off of someone else. But you also run the risk of confirmation bias. What do you think about that?

One of my bosses early in my career said that whenever someone walks into my office with an investment idea, let your first thought be a positive one.

I thought that was really powerful because sometimes the best ideas at the time you're coming up with them sound a little crazy, you know? And so I think that idea of first being positive and it's very easy to be negative about everything.

What do you think about cyclicality and investing?

I would say don't shy away from it, right, don't shy away from anything. Look at everything.

And the more you look at things and the more you study them and the more curious you are, you're going to find opportunity and you don't know where you're going to find it until you start looking.

So, I wouldn't ever start with any blanket rules that say this industry is something I'm not going to look at. Look at everything. Look at banks. Look at oil companies. Just broaden your horizons and the more you dig and more stones you turn over, the more likely it is you'll end up in a spot in finding some opportunity.

How much do you watch macro, if at all?

You know what's funny? There's this idea that there's bottom-up investing, and there's macro investing and they're two different schools. There are some businesses where you don't need a lot of macro, take a brewery, where, if the products are in demand and you know what the capacity of the brewery is, if input costs rise you might be able to raise prices over time. And if there's a recession, probably the amount of people drinking beer on Friday night isn't going to change a whole lot. So there are a few businesses that aren't super macro dependent, but this idea that you can come up with a view for business without any macro like 100% bottom-up, that doesn't make sense to me. I wrote one of my annual letters about this years ago that the role of economic forecasting in in valuing businesses is misunderstood.

If you're coming up with an estimate of intrinsic value, you should be thinking about cash flows over 20 years, 25 years. So what happens the next two or three years will have some impact, but what's more important is you know what's the return on capital of a business and the enduring competitive nature of it, all those sorts of things for a business.

Study these things, not economic forecasting. If you're finding that the economic forecasting is so vital, I would say that those businesses aren't at a big enough discount to intrinsic value to bother with.

What advice would you have for upcoming investors and the readers of this newsletter?

Read all you can, be curious.

> “When it comes time for a job, look to work for somebody with high integrity. I'd also say, take all the responsibility you can early in your career. There will be junctures where you feel like you're not ready for it, but take it anyways, it will accelerate your learning.”

I'd also say make sure it's fun. You know that every job has a bit of drudgery in it, and that's why they call it, work. This business definitely has its bad days, but if you enjoy what you're doing, you're going to be hard to compete with.